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Briefing
New EU sustainability disclosure and due diligence rules

INSTITUTE OF DIRECTORS IN IRELAND

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Our society now recognises the importance to our future of environmental, social and governance ("**ESG**") considerations. This importance will only continue to grow as a consequence of a rapidly changing legal and regulatory environment and because investors, stakeholders and law-makers are now more focused on ESG matters – risks and opportunities - than ever before.

But this can represent a challenge to companies and their Boards. The breadth of issues covered by the "ESG" banner can make it challenging for businesses to understand what they must do to manage these risks and opportunities. COVID-19 has acted as an ESG accelerant and enabled an important link to be drawn between climate change, economic growth and wider sustainability and social objectives.

Recent years have seen an increased legislative focus at European level on ESG-related issues. This legislative focus aims to:

- make companies more accountable for their impact;
- avoid greenwashing;
- direct capital towards more sustainable companies and investments;
- allow investors to take into account sustainability-related risks and opportunities; and
- identify risks which could threaten financial and economic stability.

This briefing covers key European legislative developments in this area which directors should be aware of, being the Corporate Sustainability Reporting Directive, the Taxonomy Regulation and the proposed Corporate Sustainability Due Diligence Directive.

Corporate Sustainability Reporting Directive ("CSRD")

The CSRD amends the existing reporting requirements of the Non-Financial Reporting Directive ("**NFRD**") to introduce more detailed reporting requirements regarding sustainability issues such as environmental rights, social rights, human

rights and governance factors. The CSRD must be transposed into domestic Irish legislation by 6 July 2024.

The CSRD will oblige in-scope companies to disclose information on their societal and environmental impact connected with their own operations and with their value chain. The CSRD requires companies to apply a "double materiality perspective", that is, in scope companies must report on how sustainability matters affect their business and report on the impact their business has on people and the environment.

Subject to certain limited exceptions, CSRD will apply to all large companies and all companies with debt or equity listed on EU regulated markets. Large companies are those that exceed at least two of the following criteria: 250 employees, €40m net turnover and/or €20m balance sheet total. It will also apply to parent companies of large groups where the group collectively meets the large company criteria. In certain circumstances, non-European companies may be required to produce a sustainability report where they generate a net turnover of €150 million in the EU and have at least one subsidiary or branch in the EU with a net turnover over €40m.

The CSRD requires granular reporting on a range of sustainability matters using mandatory European Sustainability Reporting Standards ("**ESRS**"). On a practical level for directors, this will involve extensive data collection and will require a well-run internal process and strong project management. Another important development from a director's perspective is the requirement for an external audit, initially on a limited assurance basis but ultimately moving towards reasonable assurance towards the end of the decade. Reporting will need to be certified by an accredited independent auditor or certifier and published in a dedicated section of directors' reports. The CSRD also requires companies to prepare the reported information in an electronic reporting format, so it is machine readable with the information ultimately becoming available through a European single access point (once developed).

The CSRD will apply on a phased basis:

- reporting in 2025 on the financial year 2024 for companies already subject to the NFRD;
- reporting in 2026 on the financial year 2025 for companies that are not currently subject to the NFRD;
- reporting in 2027 on the financial year 2026 for listed SMEs except micro undertakings, small and non-complex credit institutions and captive insurance undertakings. An opt-out will be possible for in scope SMEs for the first two years; and
- reporting in 2029 on the financial year 2028 for in scope third-country undertakings.

The European Financial Reporting Advisory Group ("**EFRAG**") is responsible for producing the ESRS underpinning the CSRD. On 23 November 2022, the EFRAG announced the submission of the first set of twelve draft ESRS to the European

Commission for adoption (here). The ESRS are expected to be adopted by the European Commission by way of delegated act in June 2023. It should be noted that CSRD provides that in-scope SMEs will be subject to simplified and proportionate reporting requirements which EFRAG has indicated will be developed next year.

Taxonomy Regulation

The Taxonomy Regulation is the lynchpin of the European ESG framework as it sets out a common classification system for "environmentally sustainable" economic activities.

Article 3 of the Taxonomy Regulation provides that an economic activity will qualify as "environmentally sustainable" where that economic activity: (a) contributes substantially to one or more of the environmental objectives in the Taxonomy Regulation, (b) does not significantly harm any of the environmental objectives (known as the "*Do No Significant Harm*" principle), (c) is carried out in compliance with certain minimum safeguards and (d) complies with technical screening criteria ("**TSC**") that have been established by the European Commission.

The Taxonomy Regulation establishes six environmental objectives: climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems.

Apart from setting out a classification system for "environmentally sustainable" economic activities, the Taxonomy Regulation also provides for reporting obligations for in-scope companies. Under Article 8 of the Taxonomy Regulation, any entity which is subject to an obligation to publish non-financial information pursuant to Article 19a or Article 29a of Directive 2013/34/EU (the "**Accounting Directive**") must include in its non-financial statement information on how and to what extent the entity's activities are associated with environmentally sustainable economic activities under Articles 3 and 9 of the Taxonomy Regulation.

Commission Delegated Regulation (EU) 2021/2178 ("**Taxonomy Disclosures Delegated Act**") (here) supplements this Article 8 reporting obligation and provides key details on disclosure rules, KPIs, qualitative information and reporting templates for financial and non-financial undertakings.

The Taxonomy Regulation entered into force on 12 July 2020. Article 8 disclosures applied in respect of the first two environmental objectives (climate change mitigation and climate change adaptation) from 1 January 2022.

Delegated Regulation (EU) 2021/2139 (the "**Taxonomy Climate Delegated Act**") (here), applicable since January 2022, establishes the TSC for determining the conditions under which an economic activity qualifies as contributing substantially to these climate change objectives and whether an economic activity causes no significant harm.

More controversially, Commission Delegated Regulation (EU) 2022/1214 (here) sets out the conditions under which nuclear and natural gas energy activities can be included in the list of economic activities covered by the Taxonomy Regulation. This Delegated Regulation also amends the Taxonomy Disclosures Delegated Act to require large listed non-financial and financial companies to disclose the proportion of their activities linked to natural gas and nuclear energy. This Delegated Act applies from 1 January 2023.

Further draft delegated regulations to amend the Taxonomy Climate Delegated Act have also recently been proposed to include TSC for the climate change mitigation and adaptation objectives regarding economic activities not yet included in that Taxonomy Climate Delegated Act (as amended), including transitional activities in the transport sector such as aviation and waterborne transport.

Notwithstanding that Article 8 disclosures in respect of the remaining four environmental disclosures have applied since 1 January 2023, the Commission has only recently consulted (here) on two draft delegated regulations and accompanying annexes establishing TSC for these remaining four environmental objectives, that is:

- sustainable use and protection of water and marine resources;
- transition to a circular economy;
- pollution prevention and control; and
- protection and restoration of biodiversity and ecosystems.

On the basis that these TSC have not yet been adopted, the Commission has confirmed that reporting eligibility and alignment for the remaining four environmental objectives is not expected for reporting in 2023.

Corporate Sustainability Due Diligence Directive ("CSDDD")

On 23 February 2022, the European Commission published its proposal for the CSDDD which aims to introduce new obligations for in-scope companies to identify and, where necessary, prevent, end or mitigate adverse impacts of their activities on human rights and on the environment, and, in the case of certain larger companies, to have a plan to ensure that their business model and strategy is compatible with limiting global warming to 1.5 °C in line with the Paris Agreement and the objective of achieving climate neutrality by 2050.

CSDDD will apply to: EU companies (being companies formed in accordance with the legislation of an EU member state) which fulfil one of the following conditions:

a. the company had more than 500 employees on average and had a net worldwide turnover of more than €150 million in the last financial year ("**Group 1**"); or
b. the company had more than 250 employees on average and had a net worldwide turnover of more than €40 million in the last financial year provided that 50% of this net turnover was generated in one or more high impact sectors (such as the

manufacture of textiles, leather and related products, and the wholesale trade of textiles, clothing and footwear, agriculture, forestry, fisheries, the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages, as well as the extraction of mineral resource, the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment) and the wholesale trade of mineral resources, basic and intermediate mineral products) (“**Group 2**”); and

It will also apply to non-EU companies (being companies formed in accordance with the legislation of a third country) which fulfil one of the following conditions:

a. the company had a net turnover of more than €150 million in the EU in the last financial year; or
b. the company had a net turnover of more than €40 million in the last financial year provided that 50% of this net turnover was generated in one or more high impact sectors listed for Group 2 companies.

In-scope companies will be required to:

- conduct human rights and environmental due diligence and to carry out certain actions;
- integrate due diligence into all corporate policies and have in place a due diligence policy that is updated annually;
- take appropriate measures to identify actual or potential adverse human rights and environmental impacts arising from their own operations, or those of their subsidiaries, and where related to their value chains, from their established business relationships
- take action to prevent and mitigate potential adverse impacts, and bring actual adverse impacts to an end and minimise their extent;
- provide for the possibility for certain persons and organisations to submit complaints to the company in case of legitimate concerns regarding those potential or actual adverse impacts, including in the company’s value chain; and
- periodically assess the implementation of their due diligence measures in order to verify that adverse impacts are properly identified and that preventive or corrective measures are implemented, and to determine the extent to which adverse impacts have been prevented or brought to an end or their extent minimised.

In-scope companies that are not subject to reporting requirements under Articles 19a and 29a of the Accounting Directive will be required to report on the matters covered by the CSDDD and publish an annual statement on their website.

The proposal for the CSDDD is currently progressing through the EU legislative process and the provisions outlined above may be subject to change. The progress of the CSDDD can be tracked at this link. Once adopted, Member States will have two years to transpose the CSDDD into national law and the new obligations will apply on a phased basis thereafter.

Conclusion

Developments in the ESG legislative landscape have accelerated rapidly and gathered pace in recent years. As a result, Boards should ensure that ESG matters are allocated sufficient resources and time to ensure compliance with legislative requirements. Practical practices such as ensuring that ESG is a standing agenda item at Board and committee meetings, identifying upskilling opportunities for the Board and staff and integrating ESG within company policies and procedures will assist compliance. ESG legislative developments require a significant focus on data and reporting and Boards should ensure that adequate systems and procedures are in place to gather and report on relevant data and engage with supply chains who may be required to provide such data.

Further information is available from

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